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IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

NO. 382

CARL L. DANIELSON and PAULINE S. DANIELSON, Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

HELEN P. SHERMAN, Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

ESTATE OF JACOB F. SCHAFFNER, DECEASED, ELIZABETH SCHAFFNER and ERWIN MARSCH, EXECUTORS and, ELIZABETH SCHAFFNER, Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

HUGH E. McLENNAN and KATHERINE McLENNAN, Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT, AND APPENDIX

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

NO. .....

CARL L. DANIELSON, et al., Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT, AND APPENDIX

Petitioners pray that a writ of certiorari issue to review the decisions of the United States Court of Appeals for the Third Circuit in the above entitled cases, Numbers 15,826, 15,827, 15,828 and 15,829 in the Court of Appeals below.

This petition seeks review of the four cases under Rule 23(5) of the Revised Rules of this Court. The cases involve identical questions. They were consolidated in the Tax Court of the United States and on appeal.

OPINIONS BELOW

The opinion of the Court of Appeals has not yet been published in the official reporter. The case is reported at CCH 1967 STAND. FED. TAX REP. ¶ 9423 (Appendix p. 15), dissenting opinion at p. 84,168 (Appendix p. 31).

The Court of Appeals vacated the decisions of the Tax Court, opinion reported in 44 T.C. 549 (Appendix p. 45), and remanded for further proceedings.

JURISDICTION

The decrees of the Court of Appeals were entered May 2, 1967 (Appendix pps. 41-44).

Jurisdiction of this Court is invoked under 26 U.S.C. § 7482(a) and 28 U.S.C. § 1254(1).

QUESTION PRESENTED

Are the declarations of a written contract determinative of tax consequences where the Tax Court of the United States finds, upon proof by the taxpayer, that the writing does not reflect the substance of the transaction?

STATUTE INVOLVED

The relevant provision of the Internal Revenue Code of 1954, 26 U.S.C. § 7453, is as follows:

"SEC. 7453. RULES OF PRACTICE, PROCEDURE, AND EVIDENCE.

The proceedings of the Tax Court and its divisions shall be conducted in accordance with such rules of practice and procedure (other than rules of evidence) as the Tax Court may prescribe and in accordance with the rules of evidence applicable in trials without a jury in the United States District Court of the District of Columbia."

STATEMENT OF THE CASE

Petitioners and one Shukis owned all the outstanding capital stock of Butler County Loan Company ("Butler Loan"), a corporation engaged in the small loan and consumer finance businesses in Butler, Pennsylvania.

In October 1959 the stockholders decided to sell what had become a declining enterprise.

Thrift Investment Corporation ("Thrift") conducts small loan, sales finance and consumer discount businesses through several branch offices. Thrift had a branch in Butler, Pennsylvania. Upon learning that Butler Loan was for sale, Thrift sent representatives to examine the company's books. (R. 40a).[1]

Thrift then submitted an offer of "$374 per share cash in consideration for all of the common stock of the Butler County Loan Company and our usual non-compete agreement in the Butler area." (Ex. 1-A at R. 25a). The offer was accepted. (R. 41a).

Before submitting its offer, Thrift had unilaterally and secretly decided to allocate roughly 40% of the purchase price per share as consideration for the non-compete agreements of the stockholders in order that the United States Treasury would bear a part of the cost. (R. 45a, 50a).

The parties convened to close the sale at Thrift's home office on November 16, 1959. Most of the day was

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1. "R" references are to the Appendices to the parties' original briefs in the Court of Appeals. Page numbers followed by "a" and "b" refer to the Commissioner's (petitioner below) Appendix and the petitioners' (respondents below) Appendix, respectively.

consumed by negotiations to settle a dispute between petitioners and Shukis. (R. 43a).

After the stockholders compromised their differences, Thrift presented to petitioners for signature separate non-compete agreements, with names, dates and the following amounts inserted (R. 45a):

Danielson and wife	$34,569.73
Mrs. Sherman	27,485.92
McLennan and wife	20,968.52
Schaffner	12,751.13

These figures were never negotiated, as the Commissioner concedes, (R. 43b). None of the petitioners had ever seen them or any separate allocation. (R. 6b, 9b, 13b, 14b, 16b, 25b).

At Thrift's request and having been assured that the restrictive covenants were only a company form, which would reduce Thrift's taxes but would not adversely affect the petitioners, the papers were signed and petitioners were paid.[2] (R. 7b, 9b, 10b, 14b, 16b, 18b, 33b).

The Non-Competition Agreements (Ex. 3-C at R. 33a) declare that petitioners were paid these large sums of money to refrain from engaging in a competing business. Accordingly, the Commissioner of Internal Revenue views these sums as ordinary income of petitioners.[3]

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2. As an oversight, Mrs. Sherman did not sign the Non-Competition Agreement presented to her.

3. Compensation for non-competition must be reported as ordinary income by the covenantor, and may be amortized and deducted by the covenantee. *Ullman v. Commissioner*, 264 F.2d 305 (2d Cir. 1959). It was Thrift's purpose to secure the deduction in making the allocation. (R. 50a).

Petitioners view the entire amounts paid to them by Thrift as consideration for the sale of capital stock. Accordingly, they reported and claim long-term capital gains.

In proceedings before the Tax Court, petitioners carried the heavy burden of proving, in effect, that the recitals of consideration in the non-compete agreements were a sham. The Tax Court made an ultimate finding of fact that "the amounts allocated to the covenants signed by petitioners were in substance a part of the purchase price paid by Thrift for the stock of Butler Loan." (R. 46a; 44 T.C. at 555; Appendix p. 57). Thus, the Tax Court held petitioners entitled to capital gains treatment.

At the trial the Commissioner made no objection to the evidence of the surrounding circumstances, but in his post-hearing brief he contended that, absent fraud, duress or undue influence, the parol evidence should be ignored. On the contrary, said the Tax Court: "We are under no obligation to restrict ourselves to the written documents evidencing covenants not to compete, which, of course, would prevent us from arriving at a decision based on all the pertinent facts. It is true, however, that we do not view written agreements lightly, and our decisions generally reflect an adherence to this principle." (R. 47a; 44 T.C. at 556; Appendix p. 57).

The case was argued before a three-member panel of the Court of Appeals on the Commissioner's Petition for Review. On December 20, 1966, rehearing before the Court *en banc* was held pursuant to Order entered *sua sponte*.

On May 2, 1967, the cases were decided. The factual findings of the Tax Court were accepted (Appendix p. 19, 27). But a 4-3 majority of the Court, referring to the parol evidence rule, adopted the following new rule of law: "A party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc." (Appendix pps. 22-23, 30).

The decision of the Tax Court was vacated and the cases remanded to allow petitioners a further opportunity to produce evidence in accordance with the new rule of law.

This Petition invites the Court's review of the Third Circuit's new rule of law as well as the Commissioner's tactics of acquiescing in the introduction of parol evidence and then challenging its admissibility after trial.

REASONS FOR GRANTING WRIT

The decision of the Court of Appeals is based upon a point of law which raises a number of important questions concerning the philosophy and imposition of federal taxation.

The Court below holds that petitioners must pay a tax at ordinary rates because they improvidently signed a contract declaring that certain sums of money were paid to restrain them from competition.

Other taxpayers in the same circumstances as petitioners may enter the same kind of transaction, for precisely the same reasons and with the same expectations; if such other taxpayers do not sign a form containing an allocation of consideration they are taxed at capital gain rates. *Estate of Masquelette v. Commissioner*, 239 F.2d 322 (5th Cir. 1956).

Does the federal taxing statute permit the disparate results, *solely* by reason of an executed form which has "no independent basis in fact or arguable relationship with business reality?" A philosophy which indicates the contrary was stated by this Court in *U.S. v. Gilmore*, 372 U.S. 39, 48 (1963):

> ". . . We should be slow to attribute to Congress a purpose producing such unequal treatment among taxpayers, resting on no rational foundation."

Other decisions of this Court hold that imposition of federal taxation may not be controlled or limited by state laws on the theory that:

> ". . . the revenue laws are to be construed in the light of their general purpose to establish a

> nationwide scheme of taxation uniform in its application. Hence their provisions are not to be taken as subject to state control or limitation unless the language or necessary implication of the section involved makes its application dependent on state law. *Burnet v. Harmel,* 287 U.S. 103, 110; *Morgan v. Commissioner,* 309 U.S. 78, 81." *U.S. v. Pelzer,* 312 U.S. 399, 402-03 (1941).

Cf. Commissioner v. Bosch, 35 U.S. Law Week 4542 (June 6, 1967).

Here, the majority of the Third Circuit holds that the tax burden incident to the sale of a business depends not upon the real nature and substance of the transaction, but upon the ability of a taxpayer in litigation with the Commissioner to prove "fraud, duress, undue influence and the like." These common law concepts, which of course may vary among the states and are subject to change by state courts and legislatures, thus become pivotal issues on a matter of federal taxation.

The Tax Court in this case stated explicitly: "For its part, Thrift intended to purchase the receivables of Butler Loan. It merely calculated the premium it would pay for such a purchase and then unilaterally attempted to change the tax treatment by calling the payment a covenant not to compete." (R. 50a; 44 T.C. at 557; Appendix p. 60). In *Bartels v. Birmingham,* 332 U.S. 126 132 (1947), this Court held that private contractual arrangements designed to shift tax liability by written declarations are ineffectual for such purposes.

> ". . . We do not think such a contractual arrangement authorizes the Commissioner to collect taxes from one not covered by the taxing statute."

Accepting the findings of the Tax Court, the majority of the Third Circuit has adopted a rule and applied it in a way that permits Thrift and other crafty taxpayers to accomplish what this Court there said may not be done.

This Court has rendered a number of instructive decisions for determining tax consequences of transactions evidenced by writings.[4] Invariably the touchstone has been the equity principle of substance over form. As stated in *Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252, 255 (1939):

> ". . . In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written contracts are not rigidly binding."

By requiring the Tax Court to follow the rules of evidence applicable in non-jury trials in the District of Columbia, Section 7453 of the 1954 Internal Revenue Code signifies the imprimatur of Congress for the substance over form philosophy.[5]

Accordingly, in countless numbers and types of tax cases, the consequences of private written contracts

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4. *E.g.*: *Bisner v. Macomber*, 252 U.S. 189 (1920); *Gregory v. Helvering*, 293 U.S. 465 (1935); *Griffiths v. Commissioner*, 308 U.S. 355 (1939); *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945).

5. As originally enacted, this provision referred to rules of evidence applicable in equity courts of the District of Columbia. 44 Stat. 1107 (1926). Its purpose appears plainly from the comment in 1925 of Chairman Green of the House Ways and Means Committee: ". . . [T]here can be no broader rule than that in equity cases as it admits everything that will affect the results." 67 Cong. Rec. 1143 (1925). The present wording merely conforms to the procedural merger of law and equity. 1954 U.S. Code Cong. and Adm. News 4581.

have been determined on the basis of the real nature and substance of the transaction, as evidenced by all the pertinent facts and not just the paperwork. In *Chisholm v. Commissioner,* 79 F.2d 14, 15 (2d Cir. 1935), cert. den. 296 U.S. 641, Judge Learned Hand explained:

> ". . . The question always is whether the transaction under scrutiny is in fact what it appears to be in form; a marriage may be a joke; a contract may be intended only to deceive others; an agreement may have a collateral defeasance. In such cases the transaction as a whole is different from its appearance. True, it is always the intent that controls; and we need not for this occasion press the difference between intent and purpose. We may assume that purpose may be the touchstone, but the purpose which counts is the one which defeats or contradicts the apparent transaction, not the purpose to escape taxation which the apparent, but not the whole, transaction would realize."

It has been held that the approach is no different whether it is the Commissioner or the taxpayer who seeks to show what really happened. *Helvering v. Tex-Penn Oil Co.,* 83 F.2d 518 (3d Cir. 1936), aff'd. 300 U.S. 481 (1937); *Landa v. Commissioner,* 206 F.2d 431 (D.C. Cir. 1953), 211 F.2d 46 (1954).

The new rule devised by the Commissioner and adopted in the Third Circuit undercuts the substance over form philosophy in an important and much litigated area. The proper approach to these non-compete cases, according to the majority below, "is of ever-increasing concern because of the frequent use of such

covenants in connection with the sales of business."[6] (Appendix p. 15-16).

The Third Circuit's decision in the cases at bar is the first to hold a taxpayer rigidly bound to paperwork which he is maneuvered into signing, and which the trial court found was devoid of reality.

In conflict with this new rule is the so-called "strong proof" rule of the Tax Court, which in essence requires a taxpayer to adduce strong proof that the written declarations of his contract have no independent basis in fact and no arguable relationship with business reality. (R. 47a-48a; 44 T.C. at 556; Appendix p. 58). Other Courts of Appeals have approved the strong proof rule.[7]

Each of the cited cases was decided upon all the pertinent facts. Neither the trial courts nor the reviewing courts relied solely upon the executed covenants. The covenants there involved, however, were not found devoid of reality and the taxpayers' challenges failed.

Here, the facts having brought a different result in the Tax Court, it is held by a 4-3 majority of the Third Circuit that the facts don't count. Evidence of surrounding circumstances to prove that the purpose and substance of the transaction are not reflected accurately

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6. See Note, 67 Yale L.J. 1261 (1958) and Wolfen, "Tax Effects of Covenants Not to Compete," N.Y.U. 12th Inst. on Federal Taxation 1047 (1954).

7. *Ullman v. Commissioner*, 264 F.2d 305 (2d Cir. 1959); *Balthrope v. Commissioner*, 356 F.2d 28 (5th Cir, 1966); *Montesi v. Commissioner*, 340 F.2d 97 (6th Cir. 1965); *Yandell v. U.S.*, 315 F.2d 141 (9th Cir. 1963); *Hamlin's Trust v. Commissioner*, 209 F.2d 761 (10th Cir. 1954).

in the forms is held inadmissible when offered by the taxpayer.

This conflict should be resolved as soon as possible.[8] Many taxpayers throughout the nation and the Internal Revenue Service must be told whether the Third Circuit's new rule is to be a rule through which taxpayers may traffic in tax results.

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8. The cases at bar have commanded attention from several services. See: Prentice-Hall Federal Taxes Report Bulletin, Vol. XLVIII, ¶ 60,273 (June 15, 1967); 16 U.S. Tax Week 820 (June 2, 1967); 35 U.S. Law Week 2670 (June 16, 1967); Institute for Business Planning, Tax Planning Ideas (June 1, 1967); 24 Tax Barometer ¶ 799 (May 12, 1967).

CONCLUSION

A new rule of law in the field of federal taxation has been adopted below. The rule represents a departure from certain fundamental principles of taxation evolved in prior decisions of this Court. The rule also operates to limit the application of Section 7453 of the Internal Revenue Code. The opinions of other Courts of Appeals are at variance with the view of the majority of the Third Circuit. The proper approach in determining tax consequences of the type of transaction here involved is of national interest and of obvious importance in Tax Court litigation.

For the foregoing reasons, the petition for writ of certiorari should be granted in these cases.

Respectfully submitted,

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Dated: July 12, 1967

Court of Appeals — Opinion.

No. 15829

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

HUGH E. McLENNAN and KATHERINE McLENNAN,
Respondents.

ON PETITIONS FOR REVIEW FROM THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

Argued September 16, 1966
Reargued December 20, 1966

Before STALEY, *Chief Judge,* McLAUGHLIN, KALODNER, HASTIE, SMITH, FREEDMAN and SEITZ, *Circuit Judges.*

OPINION OF THE COURT

(Filed May 2, 1967)

By SEITZ, *Circuit Judge.*.

This is the decision on various petitions of the Commissioner of Internal Revenue to review a decision of the Tax Court of the United States determining the tax treatment of certain payments which were recited in certain covenants not to compete to be the consideration for such covenants. That court decided that the amount explicitly allocated as payment for each selling stockholder's covenant not to compete should not, for tax purposes, be treated as having been received for such covenants. The correctness of this ruling under the par-

ticular facts is of ever-increasing concern because of the frequent use of such covenants in connection with the sales of businesses.

The taxpayers[1] were stockholders in Butler County Loan Company ("Loan"), which was engaged in the small loan business and, through a subsidiary, in the consumer finance and discount business in Butler, Pennsylvania. The husband of taxpayer, Helen Sherman, had been its successful manager until his death in 1958. Thereafter, one Shukis was brought in to run the business and was given an option to buy 100 shares of the Loan's stock. He later exercised an option to buy 10 shares.

In 1959, the stockholders decided to solicit offers to purchase what was then a declining business. On November 2, 1959, Thrift Investment Corporation ("Thrift") offered in writing to buy all the common stock of Loan for $374 per share and "our usual non-compete agreement in the Butler area". The amount of Thrift's offer was higher than it would otherwise have been because Thrift "passed on" to the selling stockholders part of the favorable tax benefits which it inferred would accrue to it because the amount paid over and above the actual value of the stock was amortizable.[2]

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1. The several taxpayers here involved kept their books and filed their income tax returns on a calendar year basis for 1959, the tax year here involved.

2. The Tax Court found as a fact that "Thrift decided to offer the stockholders of Butler Loan the book value of its assets plus 6 times excess earnings as an inducement to sell. This sum ($60,000) was divided by 55 per cent to reflect the tax effects which would accrue to Thrift if the amount were amortizible by them." 44 T. C. 549, 552 (1965). The Tax Court noted that $60,000 ÷ 55% = $109,000. An official of Thrift testified that it was that company's policy to offer slightly less than the maximum amount in initial negotiations." Idem.

All the stockholders but Shukis accepted Thrift's offer. He notified Thrift that he was exercising his option to buy 90 additional shares. He apparently was willing to sell only if he was treated as holding 100 shares.

On the same day that it heard from Shukis, November 5, 1959, Thrift forwarded to the President of Loan copies of the proposed agreement of purchase and copies of the non-competition agreement. The proposed covenant not to compete restrained the stockholders from engaging in the small loan business around Butler, Pennsylvania for approximately six years. However, it permitted them to own stock of any small loan corporation. The agreement contained a blank, which was presumably to be filled in later, representing that part of the total consideration which was to be allocated to the covenant not to compete.

Because of Shukis' action, a dispute arose between him and the other stockholders. Nevertheless, the settlement was fixed for November 16, 1959. At that time all the stockholders were present along with representatives of Thrift. All the stockholders except Shukis had one attorney. He had his own counsel present.

Thrift made it clear, of course, that the stockholder dispute would not cause it to increase the offering price for all outstanding shares. Thus, the cost of issuing any additional shares to Shukis would have to be shouldered by the other stockholders. Protracted negotiations took place that day between Shukis and the other stockholders. They finally reached a settlement. Thrift thereupon completed the agreements with Shukis and then with the other stockholders, the taxpayers herein.

Thrift allocated $152 per share to the covenant not to compete and $222 to the contract for the sale of stock. These figures were inserted in the documents. Some question was then raised by the taxpayers as to the tax treatment they would receive on the $152 per share allocated to the covenant. As found by the Tax Court, the Thrift officials explained that the allocations were to Thrift's tax advantage but they did not tell the stockholders that they (the stockholders) would receive capital gains treatment. Nor did Thrift make any attempt to explain to the stockholders that such amounts would be taxable to them as ordinary income. After a brief discussion with their own attorney concerning the allocation, the stockholders here involved, on the advice of their own counsel, signed the documents. Each payment check from Thrift contained the notation that it represented the consideration for both the sale of the stock and the agreement not to compete.

Each taxpayer reported the entire amount received by him as proceeds from the sale of capital assets.[3] The Commissioner disallowed that portion which corresponded to the consideration recited in the covenant not to compete and issued a notice of deficiency. The taxpayers then petitioned for a redetermination of the deficiency. The Tax Court ruled in favor of the taxpayers on the present issue, 44 Tax Court 549 (1965), thus permitting the consideration allocated to the covenants to be taxed at capital gains rates rather than as ordinary income. It found in effect that the taxpayers produced

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3. Thrift amortized that part of the payment which had been allocated to the covenant not to compete and the Commissioner has preserved his position with respect to that matter, presumably pending this determination.

strong proof that the covenants were not realistically bargained for by the parties and that the amounts allocated thereto by Thrift were in reality that part of the purchase price of the stock which represented a premium on corporate receivables.

The Commissioner filed these petitions for review and this is the decision thereon.

The Commissioner argues here, as he did before the Tax Court, that where the parties to a transaction involving the sale of a business have entered into a written agreement spelling out the precise amount to be paid for a covenant not to compete, they should not then be permitted, for tax purposes, to attack such provision except in cases of fraud, duress or undue influence.

The taxpayers counter by saying that such an approach would dignify form at the expense of substance and that the substance of this transaction, as found by the Tax Court, shows that the amounts allocated in the agreements for the covenants had no independent basis in fact or arguable relationship with business reality.

We address ourselves to the soundness of the rule contended for by the Commissioner because we are satisfied that if it is basically not acceptable then the factual findings of the Tax Court would compel us to affirm its decision in favor of these taxpayers. We say this because we think we could not, on this record, disturb the Tax Court's findings that the covenants were not fully restrictive in view of their wording and also because these particular stockholders were not realistically in a position to compete. In contrast, if the Commissioner's proposed rule is accepted, the factual findings of the

Tax Court would require us to reverse its decision. This is so because after Thrift first evidenced its intention to make an allocation to the covenants not to compete the taxpayers had almost two weeks in which to investigate the tax consequences. Nevertheless, they entered into the agreement on the advice of their own counsel. The present record does not reveal that the taxpayers lacked a full understanding of the terms of the agreement or that the purchaser engaged in fraud, duress, or undue influence. We do not understand either the Tax Court or the dissent to view the facts any differently.

We note at the outset that it is almost as important to delineate some of the matters which are not before us as it is to determine the applicable legal principle. First, since we are dealing with an issue as to the applicability of the correct legal principle, we are not concerned with the "clearly erroneous" rule. Compare Commissioner v. Duberstein, 363 U.S. 278 (1960). "[T]he question here is not one of 'fact,' but consists rather of the legal standard required to be applied to the undisputed facts of the case." United States v. General Motors, 384 U.S. 127, 141 (1966).

Next, we are not here involved with a situation where the Commissioner is attacking the transaction in the form selected by the parties, e.g., Schulz v. C. I. R., 294 F.2d 52 (9th Cir. 1961). Where the Commissioner attacks the formal agreement the Court involved is required to examine the "substance" and not merely the "form" of the transaction. This is so for the very good reason that the legitimate operation of the tax laws is not to be frustrated by forced adherence to the mere form in which the parties may choose to reflect their

transaction. Gregory v. Helvering, 293 U.S. 465 (1935); C. I. R. v. Court Holding Co., 324 U.S. 331 (1945). In contrast, the Commissioner here is attempting to hold a party to his agreement unless that party can show in effect that it is not truly the agreement of the parties. And to allow the Commissioner alone to pierce formal arrangements does not involve any disparity of treatment because taxpayers have it within their own control to choose in the first place whatever arrangements they care to make.

We turn, then, to a consideration of the principle advanced by the Commissioner. We begin by noting that the determination as to whether a covenant not to compete was actually executed is important, taxwise, both to the buyer and the seller. A tax challenge aside, the amount a buyer pays a seller for such a covenant, entered into in connection with a sale of a business, is ordinary income to the covenantor and an amortizable item for the covenantee. Ullman v. Commissioner, 264 F.2d 305 (2nd Cir. 1959). Indeed, the presumed tax consequences of the transaction may, as here, help to determine the total amount a purchaser is willing to pay for such a purchase. Therefore, to permit a party to an agreement fixing an explicit amount for the covenant not to compete to attack that provision for tax purposes, absent proof of the type which would negate it in an action between the parties, would be in effect to grant, at the instance of a party, a unilateral reformation of the contract with a resulting unjust enrichment. If allowed, such an attack would encourage parties unjustifiably to risk litigation after consummation of a transaction in order to avoid the tax consequences of their

agreements. And to go behind the agreement at the behest of a party may also permit a party to an admittedly valid agreement to use the tax laws to obtain relief from an unfavorable agreement.

Of vital importance, such attacks would nullify the reasonably predictable tax consequences of the agreement to the other party thereto. Here the buyer would be forced to defend the agreement in order to amortize the amount allocated to the covenant. If unsuccessful, the buyer would lose a tax advantage it had paid the selling-taxpayers to acquire. In the future buyers would be unwilling to pay sellers for tax savings so unlikely to materialize.

Finally, this type of attack would cause the Commissioner considerable problems in the collection of taxes. The Commissioner would not be able to accept taxpayers' agreements at face value. He would be confronted with the necessity for litigation against both buyer and seller in order to collect taxes properly due. This is so because when the Commissioner tries to collect taxes from one party he may, as here, dispute the economic reality of his agreement. When the Commissioner turns to the other party, there will likely be the arguments that the first party, as here, received consideration for bearing the tax burden resulting from the sale and that the covenants did indeed have economic reality.

For these reasons we adopt the following rule of law: a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties

to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc. Because of the importance of our conclusion as to the proper rule of law here applicable, we deem it appropriate to consider other cases which have been decided in this particular field.

We first consider the case law in this Circuit. The first was Mathews v. C. I. R., 311 F.2d 795 (1963). This was a per curiam opinion filed in January 1963. It affirmed the decision of the Tax Court without discussion.[4] In that case the sole stockholder sold the corporate stock and assets for a fixed consideration and also agreed to execute a covenant not to compete for a stipulated additional amount. In his tax return the selling-taxpayer attempted to treat the payment for the covenant as a payment for a capital asset rather than ordinary income. The Commissioner challenged such treatment and the Tax Court apparently decided that petitioner did not sustain the required burden for upsetting the allocation in that it found that the covenant had indepedent substance which could be equated with the payment therefor. The rule here advanced was apparently not raised.

The second case in this Circuit is Levine v. C. I. R., 324 F.2d 298 (1963). There the agreement, which included covenants not to compete, recited that in computing the purchase price an explicitly stated valuation was placed on the covenants. The selling partners (taxpayers) apparently did not consider any of such

4. It cites the Tax Court opinion as appearing in 36 T. C. 483, whereas it is found in 20 T. C. M. 1565.

proceeds as payment for the covenants because they did not report any part as ordinary income for tax purposes. The Commissioner claimed that it was all paid for the covenant. The Tax Court found as an ultimate fact that half of the amount was paid for good will and half for the covenant. See 21 T. C. M. 363.

In the review proceedings, this Court was apparently not confronted with the contention here advanced that the taxpayer should be held to the allocation set forth in the agreement because of the wording of the agreement itself. Rather, the Court in affirming concerned itself solely with the question of the propriety of the Tax Court's allocation as between good will and the covenant not to compete.

In turning to other Circuits we find that one of the leading cases is the Second Circuit opinion in Ullman v. C. I. R., 264 F.2d 305 (1959). There the selling-taxpayers, for tax purposes, treated the amounts specifically allocated in their agreements for their covenants not to compete as part of the purchase price for their stock. Before the Tax Court, the Commissioner successfully resisted this treatment on the facts, with the consequence that the consideration for the covenant was treated as income. The Second Circuit, in upholding the Tax Court, applied the rule "that when the parties to a transaction such as this one have specifically set out the covenants in the contract and have there given them an assigned value, strong proof must be adduced by them in order to overcome that declaration." 264 F.2d 305, 308.

The first case of importance in the Fifth Circuit is Barran v. C. I. R., 334 F.2d 58 (1964). There the Court

applied the rule of the Second Circuit in the *Ullman* case. However, a reading of the second footnote in that case leaves it unclear whether the Court refused to apply the rule we have formulated or merely found it unneccessary to consider it under the facts of that case. Its findings suggest that the latter construction of the footnote is probable. See also Balthrope v. C. I. R., 356 F.2d 28 (5th Cir. 1966); Montesi v. C. I. R., 340 F.2d 97 (6th Cir. 1965).

There are several cases in this field decided by the Ninth Circuit. The first is Rogers v. U. S. A., 290 F.2d 501 (1961). There the Court affirmed the action of the trial court in refusing the covenantor's request to go behind the covenant and the consideration allocated thereto. Explicit reliance was placed on Hamlin's Trust v. Commissioner of Internal Revenue, 209 F.2d 761 (10th Cir. 1954), which we shall later consider. The Court noted that "Third parties may question the resolutions of parties to a contract, but in the absence of fraud it is not ordinarily open to the bargainers to do so." 290 F.2d 501.

The case of Schulz v. C. I. R., 294 F.2d 52 (9th Cir. 1961), is inapplicable because the attack on the consideration received for the covenant was made by the Commissioner.

The next Ninth Circuit case is Annabelle Candy v. C. I. R., 314 F.2d 1 (1962). In that case the execution of a covenant was required by the terms of the agreement but no specific amount was allocated to the covenant on the face of the writing. There the taxpayer-purchaser was attempting to make an allocation for tax purposes, in contrast to the reverse situation here where the tax-

payers are attempting to dispute an allocation for tax purposes. It is of moment to note that in the opinion the Court stated as follows:

> "In the purchase agreement involved in the case before us, there is no allocation of consideration to the covenant not to compete. While this is pretty good evidence that no such allocation was intended it is not conclusive on the parties as would be the case if there had been an express affirmance or disavowal in the agreement." 314 F.2d 1, 7.

Thus, while the case is distinguishable from the situation involved here, the Court appears to suggest the same approach to the tax determination process that we have adopted.

The last Ninth Circuit case is Yandell v. U.S.A., 315 F.2d 141 (1963). There the Court upheld the trial court's decision that the written agreement concerning a covenant not to compete with a stipulated consideration therefor was binding on the covenantor for tax purposes. The Court noted that it did not have to consider the applicability of the rule here advanced.

We come finally to the important Tenth Circuit Court opinion in Hamlin's Trust v. C. I. R., 209 F.2d 761 (1954). The Commissioner places heavy reliance on this opinion in the present petitions for review. The *Hamlin* case arose in the same way as the cases now before us except that the Tax Court found that the amount allocated in the agreement for the covenants not to compete was to be treated as ordinary income. On review, in affirming the Tax Court, the Court held the taxpayers to their agreement despite some evidence which was quite similar to that found here.

We interpret the language of the *Hamlin's Trust* case as reflecting in substance the principle here espoused even though we concede that the evidence may have called for the same result no matter what the rule.

By way of generalization, we note that in none of the cases discussed in which the taxpayer attacked the formal agreement was there any factual situation which warranted a finding, apart from the writing, that the taxpayer had sustained his burden of strong proof. However, we are here confronted with that very situation because of the factual findings of the Tax Court which we accept. Even in these circumstances, we are inclined to believe that the "strong proof" rule would require that the taxpayer be held to his agreement absent proof of the type which would negate it in an action between the parties to the agreement. If our belief is unwarranted then we nevertheless conclude that a taxpayer who enters into a transaction of this type to sell his shares and executes a covenant not to compete for a consideration specifically allocated to the covenant may not, absent a showing of fraud, undue influence and the like on the part of the other party, challenge the allocation for tax purposes. We so conclude even though the evidence, as here, would support a finding that the explicit allocation had no independent basis in fact or arguable relationship with business reality. Such evidence can have no independent legal significance in cases where the consideration is allocated by the parties in their agreement. It would be relevant, but not conclusive, evidence only if some attack is made on the written agreement by a party claiming that because of fraud, etc., it is not his conscious agreement.

If it is assumed that the taxpayers were unaware of the tax consequences when they consciously accepted the allocation to the covenants not to compete—although the Tax Court did not make a finding to that effect—the following observations from Hamlin's Trust v. C. I. R., 209 F.2d 761, 765 (10th Cir. 1954), are pertinent:

> "* * * It is true that there was very little discussion of the suggested allocation [to the covenant not to compete]. But the effectiveness taxwise of an agreement is not measured by the amount of preliminary discussion had respecting it. It is enough if parties understand the contract and understandingly enter into it. The proposed change in the contract was clear. All parties participating in the conference agreed to it. The owners of stock present signed the written contract at the time and others signed it later. It is reasonably clear that the sellers failed to give consideration to the tax consequences of the provision, but where parties enter into an agreement with a clear understanding of its substance and content, they cannot be heard to say later that they overlooked possible tax consequences. While acting at arm's length and understandingly, the taxpayers agreed without condition or qualification that the money received should be on the basis of $150 per share for the stock and $50 per share for the agreement not to compete. Having thus agreed, the taxpayers are not at liberty to say that such was not the substance and reality of the transaction."

In any event, it is not improbable that the selling-taxpayers in the end would have entered into such an agreement even though they fully understood the tax

consequences of the allocation. This is so because had they insisted on elimination of the covenants not to compete Thrift would not have offered them as high a purchase price for their stock.

There are of course a few circumstances in which taxpayers have been permitted to escape taxation based on their own conscious agreements. In Helvering v. Lazarus & Co., 308 U.S. 252 (1939), the Supreme Court noted that one who must "bear the burden of exhaustion of capital investment" is entitled to a deduction for depreciation regardless of the fact that the taxpayer by agreement designated another as the legal owner. Similarly, in Bartels v. Birmingham, 332 U. S. 126 (1947), the Supreme Court stated that "in the application of social legislation" such as the Social Security Act, "it is the total situation that controls" liability for employment taxes regardless of the fact that the taxpayer by agreement designated itself as the employer.

In contrast, in the present situation there is no discernible policy which would require that the incidence of taxation fall upon a particular individual. As a result of the circumstance that an amount allocable to a covenant not to compete is amortizable by the buyer and ordinary income to the seller, it generally does not matter what amount is allocated. And where a loss of tax revenues from one taxpayer cannot be retrieved entirely from another because of differentials in tax brackets or other factors the Commissioner may challenge the allocation as not reflecting the substance of the transaction.

We find, therefore, no reason why the Commissioner may not treat as ordinary income of the taxpayers that

part of the total consideration which was explicitly allocated to covenants not to compete with the buyer. Of course, it would be unfair to assess taxes on the basis of an agreement the taxpayer did not make. Compare Helvering v. Tex-Penn Oil Co., 300 U. S. 481 (1937). Many factors may be relevant to the search for the agreement which the parties consciously made, including the business reality of the transaction. However, under the rule here adopted, if either of the parties to a covenant not to compete attempted, in an action against the other, to avoid or alter the agreement he would have a heavy burden of showing fraud, duress, undue influence and the like under what may loosely be called common-law principles. In such a situation the parol evidence rule could come into play to restrict the type of evidence the attacking party might adduce. Thus, a question arises whether this contemplated application of the parol evidence rule is precluded in tax controversies.

First, 26 U. S. C. § 7453 of the Internal Revenue Code makes applicable the District of Columbia rules of evidence in Tax Court proceedings. However, even if parol evidence would be admissible in a District of Columbia tax case like the present, the statute would not make such a rule controlling here because under the modern view the parol evidence rule is a rule not of evidence but of substantive law. 3 Corbin on Contracts, Sec. 573.

Second, there is language in some federal tax cases to the effect that the parol evidence rule does not apply to controversies between the Commissioner and a party to the contract. Landa v. C. I. R., 206 F.2d 431 (D. C.

Cir. 1953); Scofield v. Greer, 185 F.2d 551 (5th Cir. 1950). But we prefer to follow those decisions which hold that the Commissioner may assert the parol evidence rule in circumstances such as the present.

> "That by some other form of instrument the rights of the United States would have been different is beside the question. The parties abide by this instrument as they made it. The law, and not their wish or understanding, must control its legal effect on the incidence of taxation." Pugh v. C. I. R., 49 F.2d 76, 79 (5th Cir. 1931).

See also Sherman v. C. I. R., 76 F.2d 810 (9th Cir. 1935); Jurs v. C. I. R., 147 F.2d 805 (9th Cir. 1945); Gaylord v. C. I. R., 153 F.2d 408 (9th Cir. 1946); C. I. R. v. Dwight's Estate, 205 F.2d 298 (2nd Cir. 1953); Campbell v. Lake, 220 F.2d 341 (5th Cir. 1955); Clark v. United States, 341 F.2d 691 (9th Cir. 1965).

Even if the parol evidence rule were not applicable in tax controversies of the type under consideration, examination of all the evidence adduced in this case reveals nothing to demonstrate that the contract as written was not the taxpayers' conscious agreement.

Therefore, the decision of the Tax Court which disallowed the Commissioner's assessments must be vacated. The case is remanded to the Tax Court so that the parties may be afforded a further opportunity to produce evidence in accordance with the principles expressed in this opinion.

STALEY, *Chief Judge,* dissenting.

The majority of this court adopts an arbitrary rule of exclusion to be applied in tax cases. Both the Com-

missioner and the majority admit that it is a *new rule.* To achieve its result, the majority has had to overrule not only a long line of decisions of this court, but, in my view, has disregarded a long line of decisions of the United States Supreme Court holding to the contrary. It admits, as it must, that there is no judicial precedent for its decision.

Since Eisner v. Macomber, 252 U.S. 189, the United States Supreme Court has consistently held "In order, therefore, that the clauses cited from Article I of the Constitution may have proper force and effect, save only as modified by the Amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not 'income,' [as the term is there used; and to apply the distinction, as cases arise, *according to truth and substance, without regard to form.*"] *Id.* at 206 (Emphasis added.) That case was decided in 1919. This was reiterated in Weiss v. Stearn, 265 U.S. 242, 253 (1924), and the Court stated that "Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants; and when applying the provisions of the Sixteenth Amendment and income laws enacted thereunder we must regard matters of substance and not mere form." 265 U.S. at 254.

Again in Gregory v. Helvering, 293 U.S. 465 (1935), the Court went behind a formal compliance with the tax-free reorganization provisions, stating that "To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." *Id.* at 470. The very next year in Helvering

v. Tex-Penn Oil Co., 300 U.S. 481, the Supreme Court affirmed the judgment of this circuit, 83 F.2d 518 (C.A. 3, 1936), that the recitals of a written contract could be rebutted by extraneous evidence if necessary to show the real agreement; indeed "* * * in determining tax liability, taxing authorities must look through form to fact and substance." 300 U.S. at 492-93, quoting 83 F.2d at 522.

Later in Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1939), the Court said "In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." *Id.* at 255. The rule of these cases has been applied in hundreds of other cases and by all courts of appeal.[1]

Although citing no authority, the majority asserts that the obligation to ascertain the substance of a transaction does not apply in this case because here it is one of the parties rather than the Commissioner who seeks to show that the substance of the transaction differed from its form. This proposition does not follow from the cases; in both Helvering v. F. & R. Lazarus, supra, and Helvering v. Tex-Penn Oil Co., supra, the victorious taxpayers had attacked the form in which the transac-

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1. *See e.g.*, Palmer v. C.I.R., 354 F.2d 974, 975 (C.A.1, 1965); Lubin v. C.I.R., 335 F.2d 209, 213 (C.A.2, 1964); Ruoff v. C.I.R., 277 F.2d 222, 229 (CA.3, 1960); Meiselman v. C.I.R., 300 F.2d 666, 668 (C.A.4, 1962); Cotnam v. C.I.R., 263 F.2d 119, 122, 124 (C.A.5, 1959); Broughton v. C.I.R., 333 F.2d 492, 495 (C.A.6, 1964); Sherwood Memorial Gardens v. C.I.R., 350 F.2d 225, 228 (C.A.7, 1965); Schoenberg v. C.I.R., 302 F.2d 416, 418-19 (C.A.8, 1962); Shaw Constr. Co. v. C.I.R., 323 F.2d 316, 319-20 (C.A.9, 1963); Lacy v. C.I.R., 341 F.2d 54, 56-7 (C.A.10, 1965); Landa v. C.I.R., 206 F.2d 431, 432 (C.A.D.C., 1953); Sheppard v. United States, 361 F.2d 972, 977-79 (Ct.Cl., 1966).

tions were case, and the Commissioner had relied on the formal arrangement.[2]

Indeed the very question presented here was directly passed upon by the Supreme Court in Bartels v. Birmingham, 332 U.S. 126 (1947). There the Court of Appeals for the Eighth Circuit had held that although "* * * such a contract was not binding on the Government, they thought it was binding on the parties and would control liability for employment taxes if the Bureau of Internal Revenue chose to accept the arrangement as valid." 332 U.S. at 129. The Court went on to say

> "* * * The argument of respondents [the Commissioner] to support the administrative interpretation of the regulations is that the Government may accept the voluntary contractual arrangements of the amusement operators and entertainers to shift the tax burden from the band leaders to the operators. Cases are cited to support this position. All of these cases, however, involve the problem of corporate or association entity. *They are not pertinent upon the question of contracts to shift tax liability from one taxpayer to another wholly distinct and disconnected corporation or individual. We do not think that such a contractual shift authorizes the Commissioner to collect taxes from one not covered by the taxing statute.*" 332 U.S. at 131-32. (Emphasis added.)

That the rule for which the Commisioner sought the Supreme Court's approval in *Bartels* is precisely the rule

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2. *See e.g.*, Frelbro Corp. v. C.I.R., 315 F.2d 784, 786 (C.A.2, 1963); Landa v. C.I.R., supra, discussed infra.

which the majority has adopted today is clearly pointed up by the dissent in *Bartels*, where it was contended that "if the Government chooses to accept the contract on its face, the parties should be barred from showing that it conceals the real arrangement." 332 U.S. at 133. The majority would distinguish *Bartels* on the ground that it involved social security taxes, but the entire basis of the decision, as pointed out above, was the long-established rule of looking to substance rather than form, which is applicable to all tax cases and certainly to income tax cases. See cases supra.

Section 7453 of the Internal Revenue Code of 1954, 26 U.S.C. § 7453 (1955) provides in part: "The proceedings of the Tax Court and its divisions shall be conducted * * * in accordance with the rules of evidence applicable in trials without a jury in the United States District Court of the District of Columbia." This section is the successor to § 907(a) of the Act of 1926, 44 Stat. at 107, incorporated in the United States Code at Section 611, and re-enacted in the 1939 Code as Section 1111. After 1926, and as enacted in 1939, this section provided that the proceedings before the Board of Tax Appeals should be conducted "* * * in accordance with the rules of evidence applicable in courts of equity of the District of Columbia." The omission of the reference to equity rules in the 1954 version of the section was merely to modernize the rule, especially to bring it into conformity with the procedural merger of law and equity accomplished under the Federal Rules of Civil Procedure.

I think that this court is bound by this section of the statute and must look to the District of Columbia for its laws as to the admissibility of the evidence offered by

the taxpayers in this case. The purpose of Section 7453 and its predecessors was to avoid exactly what has occurred in this case by reason of the majority opinion; that is that the several circuits were to be precluded from adopting their own rules for tax cases and thus create conflicting rules. The majority attempts to avoid the thrust of the statute by holding that the parol evidence rule is a rule of substantive law and not a rule of evidence. We need not go into the semantical problem, *compare* McCormick, Evidence § 210 (1954) *with* Corbin, Contracts § 573 (1960) *and* Restatement, Contracts § 237 (1932), because whether it be one or the other, the statute covers it. As the Supreme Court held in Helvering v. F. & R. Lazarus, "* * * Congress has specifically emphasized the equitable nature of proceedings before the Board of Tax Appeals by requiring the Board to act 'in accordance with the rules of evidence applicable in courts of equity of the District of Columbia.' 26 U.S.C. § 611." 308 U.S. at 255.

We have taken cognizance of this provision of the Code in the past and have even gone so far as to apply an *Erie R.R.*-type extrapolation as to how the District of Columbia courts would decide a particular issue. Masters v. C.I.R., 243 F.2d 335, 338-39 (C.A.3, 1957). The District of Columbia rule to be applied here is clear. In Landa v C.I.R., supra, where the court held that the taxpayer could introduce extraneous evidence to attack the written documents, it stated:

> "* * * Generally, '[i]n the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding' *The taxpayer as*

well as the Commissioner of Internal Revenue is entitled to the benefit of this rule." 206 F.2d at 432 (Emphasis added.)

Thus, the cardinal maxim of equity that equity looks to substance, not to form, has been imported into tax jurisprudence by the United States Supreme Court in numerous cases, supra, and forms part of the body of equitable rules of admissibility of the District of Columbia, *Landa*, supra, which we are obligated to apply in the tax cases under § 7453. By finding that the taxpayers extraneous evidence has no independent legal significance, the majority not only disregards law as settled by the Supreme Court, but also an explicit command of Congress.[3]

The policy basis of the majority seems to be that allowance of the attack on the consideration allocated to

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3. Although I do not ground my dissent on these bases, it should be noted that even were the parol evidence rule applicable in these cases, it should not be applied here because it is always open to the parties to show that the true consideration for the agreement was other than that recited in the written contract. The Tax Court, this court and others have recognized this exception. In Haverty Realty & Inv. Co., 3 T.C. 161, 167 (1944), it was said that:

> "'* * * the recitals of a written instrument as to the consideration received are not conclusive, and it is always competent to inquire into the consideration and show by parol or other extrinsic evidence what the real consideration was.' Deutser v. Marlboro Shirt Co. (C.C.A., 4th Cir.), 81 Fed. (2d) 139, 142, citing many authorities."

See also, Richards v. Boyd, 344 F.2d 754 (C.A.3, 1965); Diesel Heat & Power, Inc. v. Dixon Marine Indus. Power Transmission, Inc., 232 F.2d 217 (C.A.5, 1956); Patterson v. Texas Co., 131 F.2d 998, 1000-01 (C.A.5, 1942), cert. denied, 319 U.S. 761 (1943). It is also generally well settled that a third party cannot assert the parol evidence rule. *E.g.* Bardwell v. C.I.R., 318 F.2d 786, 790 (C.A.10, 1963), *aff'g* 38 T.C. 84, 90 at n.2 (1962); Thornness v. United States, 260 F.2d 341, 345 (C.A.7, 1958); Landa v. C.I.R., supra; Scofield v. Greer, 185 F.2d 551, 552 (C.A.5, 1950); Haverty Realty & Inv. Co., 3 T.C. 161, 167 (1944) and cases cited therein.

the covenant may cause the promisee to "* * * lose a tax advantage it had paid the selling-taxpayer to acquire." However, as I read this, it opens the door wide for individuals to avoid tax consequences by artifices such as we have in this case. This result is an invitation to tax evasion. As was said of contracts to shift the tax liability from one taxpayer to another in the *Bartels* case, "We do not think that such a contractual shift authorizes the Commissioner to collect taxes from one not covered by the taxing statute." 332 U.S. at 132. As was stated in the second *Landa* opinion, "Whenever taxation is allowed to depend upon form, rather than substance, the door is opened wide to distortions of the tax laws which, after all, represent the legislative judgment for an equitable distribution of the tax burden generally." 211 F.2d 46, 50 (C.A.D.C., 1954).

The danger of distortion of the tax laws is particularly acute in this area. As noted by the majority, since the "amount allocable to a covenant not to compete is amortizable by the buyer and ordinary income to the seller, *it generally does not matter what amount is allocated.*" (Emphasis added.) The majority would have the Commissioner attack such an allocation only where the Government would suffer a net loss in revenue, apparently disregarding in all other cases the question whether the allocation was an artifice without "arguable independent basis in fact or arguable relationship with business reality," the test heretofore applied by the various circuits and the Tax Court and the Supreme Court. The difficult burden of showing fraud, etc. placed upon the parties by the majority virtually insures that knowledgeable buyers will en-

gage in questionable and sharp dealing to secure the advantages of such covenants, and the majority's rule will shield their agreements. I cannot condone this invitation given by the majority.

The unfairness of the application of the new doctrine to this particular case can best be indicated by reciting the argument advanced by the taxpayers. "Although the Court has not asked to be briefed on the point, attention must be directed to the inherent unfairness of permitting the Commissioner to cast doubt on the admissibility of parol evidence in his post-hearing brief, where he has failed to object to its admissibility when offered. Not only is time wasted by this procedural irregularity, but Respondents are prejudiced in that the evidence which they offered without objection of the Commissioner supported their basic theory of the case. Had Respondents been put on notice of the Commissioner's position, they could well have devoted their efforts to proving fraud, mistake, or undue influence, which are recognized by the Commissioner as exceptions to the parol evidence rule."

The taxpayers, at the hearing in the Tax Court, relied upon the rule that has prevailed since *Eisner v. Macomber,* and the Tax Court itself relied upon the rule. As pointed out by the Tax Court, the rule it applied in these cases was that that court would not restrict itself to the written documents but would give great weight to them, so that the burden was upon the taxpayers to adduce "strong proof" to establish that the allocations of purchase price to the covenants did not reflect the substance of the agreement entered into by the parties. 44 T.C. 549, 555-56 (1965). It is

notable that most of the cases relied upon by the Tax Court and cited by the majority purport to apply this same rule.

Even a casual reading of the record in this case indicates that a strong case can be made out for the taxpayers based upon fraud. The majority has stated that if it were not for this new rule, the factual findings of the Tax Court would compel this court to affirm the judgment in the taxpayer's favor.

I would affirm the Tax Court.

Judge Kalodner and Judge Smith join in this dissent.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

NO. 15,826

COMMISSIONER OF INTERNAL REVENUE
Petitioner
v.
CARL L. DANIELSON and PAULINE S. DANIELSON
Respondents

(T. C. Docket No. 1779-63)

ON PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES

Present: STALEY, Chief Judge, and MCLAUGHLIN, KALODNER, HASTIE, SMITH, FREEDMAN and SEITZ, Circuit Judges.

JUDGMENT

This cause came on to be heard on the record from the Tax Court of the United States, and was re-argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby vacated and the case is remanded to the Tax Court so that the parties may be afforded a further opportunity to produce evidence in accordance with the principles expressed in the opinion of this Court.

ATTEST:
M. ELIZABETH FERGUSON
M. Elizabeth Ferguson,
Chief Deputy Clerk

May 2, 1967

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

NO. 15,827

COMMISSIONER OF INTERNAL REVENUE
Petitioner

v.

HELEN P. SHERMAN
Respondent

(T. C. Docket No. 5489-63)

ON PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES

Present: STALEY, Chief Judge, and MCLAUGHLIN, KALODNER, HASTIE, SMITH, FREEDMAN and SEITZ, Circuit Judges.

JUDGMENT

This cause came on to be heard on the record from the Tax Court of the United States, and was re-argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby vacated and the case is remanded to the Tax Court so that the parties may be afforded a further opportunity to produce evidence in accordance with the principles expressed in the opinion of this Court.

ATTEST:

M. ELIZABETH FERGUSON
M. Elizabeth Ferguson,
Chief Deputy Clerk

May 2, 1967

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

NO. 15,829

COMMISSIONER OF INTERNAL REVENUE
Petitioner

v.

HUGH E. McLENNAN and KATHRINE McLENNAN
Respondents

(T. C. Docket No. 473-64)

ON PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES

Present: STALEY, Chief Judge, and McLAUGHLIN, KALODNER, HASTIE, SMITH, FREEDMAN and SEITZ, Circuit Judges.

JUDGMENT

This cause came on to be heard on the record from the Tax Court of the United States, and was re-argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby vacated and the case is remanded to the Tax Court so that the parties may be afforded a further opportunity to produce evidence in accordance with the principles expressed in the opinion of this Court.

ATTEST:

M. ELIZABETH FERGUSON
M. Elizabeth Ferguson,
Chief Deputy Clerk

May 2, 1967

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT
NO. 15,828
COMMISSIONER OF INTERNAL REVENUE
Petitioner
v.
ESTATE OF JACOB F. SCHAFFNER, Deceased, ELIZABETH SCHAFFNER and ERWIN MARSCH, Executors, and ELIZABETH SCHAFFNER
Respondents
(T. C. Docket No. 344-64)

ON PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES

Present: STALEY, Chief Judge, and MCLAUGHLIN, KALODNER, HASTIE, SMITH, FREEDMAN and SEITZ, Circuit Judges.

JUDGMENT

This cause came on to be heard on the record from the Tax Court of the United States, and was re-argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby vacated and the case is remanded to the Tax Court so that the parties may be afforded a further opportunity to produce evidence in accordance with the principles expressed in the opinion of this Court.

ATTEST:
M. ELIZABETH FERGUSON
M. Elizabeth Ferguson,
Chief Deputy Clerk

May 2, 1967

Tax Court — Opinion

44 T. C. No. 51

TAX COURT OF THE UNITED STATES

CARL L. DANIELSON and PAULINE S. DANIELSON, ET AL.,[1] Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket Nos. 1779-63, 5489-63, 344-64 and 473-64.

Filed July 12, 1965.

Held, on these facts, that amounts allocated by the purchaser to petitioners' covenants not to compete, which accompanied their sale of the stock of a small loan company, were in reality payments for corporate assets, thus making the payments so received taxable as capital gains.

Sidney B. Gambill and *Linn v. Phillips, Jr.,* for the petitioners.

Hobart Richey, for the respondent.

DAWSON, *Judge*: Respondent determined the following deficiencies in petitioners' income taxes for the year 1959:

1. The proceedings of the following petitioners are consolidated herewith: Helen P. Sherman, Docket No. 5489-63; Estate of Jacob F. Schaffner, Deceased, Elizabeth Schaffner, and Erwin Marsch, Executors, and Elizabeth Schaffner, Docket No. 344-64; and Hugh E. McLennan and Katherine McLennan, Docket No. 473-64.

Docket No.	*Petitioners*	*Deficiency*
1779-63	Carl L. and Pauline Danielson	$12,016.88
5489-63	Helen P. Sherman	4,625.30
344-64	Estate of Jacob F. Schaffner, Deceased, Elizabeth Schaffner and Erwin Marsch, Executors, and Elizabeth Schaffner	1,770.96
473-64	Hugh E. and Katherine McLennan	5,001.49

In docket No. 5489-63 Helen P. Sherman has claimed in her petition an overpayment in the amount of $2,675.81.

Petitioners sold the stock of their small loan company for $374 per share and the buyer allocated a portion thereof to separate covenants not to compete just prior to the closing. The principal issue is whether the amounts received by the petitioners pursuant to these covenants actually reflect payment for them. A secondary issue relates to the fair market value of the small loan company's stock on June 20, 1958.

FINDINGS OF FACT.

Some of the facts were stipulated by the parties and are hereby found accordingly.

Carl L. and Pauline Danielson are husband and wife residing at R.D. 6, Butler, Pennsylvania. Helen P. Sherman resides at 203 Filbert Road, Butler, Pennsylvania. Hugh E. and Katherine McLennan are husband and wife residing at 308 Castle Shannon Boulevard, Pittsburgh, Pennsylvania. Jacob F. and Elizabeth Schaffner were husband and wife during 1959, and they resided in Butler, Pennsylvania. All of the petitioners kept their books and filed their income tax returns on a calendar

year basis for 1959, using the cash receipts and disbursements method of accounting, with the district director of internal revenue at Pittsburgh, Pennsylvania.

Jacob F. Schaffner died on October 20, 1964. His executors were substituted as petitioners.

The Butler County Loan Company (hereafter called Butler Loan), a Pennsylvania corporation, was organized in 1946 by Hugh McLennan and Paul Sherman, the deceased husband of Helen Sherman. The company conducted a small loan business in Butler, Pennsylvania, in its own name and engaged in the consumer finance and consumer discount businesses through a subsidiary corporation.

Prior to forming Butler Loan, Paul Sherman had managed another loan office in Butler, Pennsylvania. Because of his experience and ability Sherman developed Butler Loan into a successful business before his death on June 20, 1958.

After Sherman's death, the stockholders called upon Alvin C. Shukis to evaluate the business. Shukis had known Sherman for many years and was then managing a loan company in Oakmont, Pennsylvania. Shukis analyzed the accounts of Butler Loan, determined that its stock had a book value of $225 per share, and concluded that it was in a healthy position and should be kept in operation. The petitioners offered the position of manager at Butler Loan to Shukis and he accepted. He received an annual salary of $8,400 plus the option to buy 100 shares of the company's stock over a 5-year period at the then book value of $225 per share. Shukis began his employment with Butler Loan on July 2, 1958.

On December 10, 1958, Butler Loan purchased the 114 outstanding shares of a stockholder who had died. The company paid $226 per share for the stock and held it in the treasury. On September 9, 1959, Shukis exercised his option to buy 10 shares of Butler Loan's stock at $225 per share. After he did so, the stock of Butler Loan was then held as follows:

Stockholders	*Shares*
Carl L. and Pauline Danielson	244
Helen P. Sherman	194
Hugh E. and Katherine McLennan	148
Jacob F. Schaffner	90
Alvin C. Shukis	10
Total	686

Carl Danielson is a physician, specializing in surgery in Butler. He has been engaged in his profession since 1931. Throughout 1959 he actively pursued his medical practice. His wife Pauline was not employed.

Helen P. Sherman is a widowed housewife who devoted her time in 1959 to maintaining her home and raising her three children.

Hugh McLennan has been in the real estate and insurance business for many years in Pittsburgh. During 1959 he actively conducted his business. His wife Katherine devoted her time to their home.

Jacob F. Schaffner was a 93 year old retired businessman in 1959 who spent his entire time at home. His wife Elizabeth handled almost all of his affairs. He maintained no active participation in any business activities, although he did attend the meetings of Butler Loan's board of directors.

On October 23, 1959, the stockholders of Butler Loan put the business up for sale by soliciting offers from other small loan companies.

Thrift Investment Corporation (hereafter called Thrift) conducts small-loan, sales finance, and consumer discount businesses in a number of branch offices. At the time Butler Loan was offered for sale, Thrift already had a branch office operating in Butler. When Thrift's officials learned that the stockholders of Butler Loan wanted to sell, Thrift sent its representatives to examine the outstanding receivables. Based on its analysis, Thrift submitted three alternative bids which were considered, along with those received from other prospective buyers, at a meeting of Butler Loan's stockholders and directors on November 3, 1959. The Thrift offers were contained in the following letter written by Paul M. Hickox, Executive Vice President, to Hugh McLennan:

> We are pleased to submit an offer of $374 per share cash in consideration for all of the common stock of the Butler County Loan Company and our usual non-compete agreement in the Butler area.
>
> While we prefer to make a cash purchase, we are willing to make an alternative offer of 24 shares of Thrift Investment Corporation common stock (available over-the-counter currently at $9.25 per share) and $152 cash. We believe that this alternative method would avoid capital gains taxes on that part of the consideration paid in stock, if all shareholders accept the alternative plan.
>
> In the event that you wish to sell the assets of the company instead of its capital stock, we would

be willing to pay $336,791 for the small loan receivables, net book value for the furniture and fixtures, and net book value for the consumer discount and sales finance receivables after deducting unearned discount. We would also assume the remainder of your lease.

We appreciate the opportunity to submit this offer and are prepared to close this transaction immediately.

Thrift based its offer of $374 per share upon the assumption that by combining Butler Loan's business with Thrift's then existing branch office in Butler, it could anticipate increased profits of $19,900. Thrift determined that it would need a return of 3 percent on Butler Loan's outstanding receivables so as not to dilute its existing holdings. The excess earnings were then computed in the following manner:

Estimated annual profit from acquisition		$19,900
Less 3% return on outstanding receivables purchased		
Small loans receivables	$264,000	
Consumer discount loans	57,000	
Sales finance loans	9,000	
Total outstanding receivables	$330,000	
3% of $330,000		9,900
Excess earnings		$10,000

Thrift decided to offer the stockholders of Butler Loan the book value of its assets plus six times excess earnings as an inducement to sell. This sum ($60,000)

was divided by 55% to reflect the tax effects which would accrue to Thrift if the amount were amoftizable by them.[2]

When the shareholders decided to accept the first of Thrift's alternate proposals, Shukis announced that he would exercise his option to purchase the 90 additional shares allotted him in his employment contract. The remaining shareholders refused to honor the exercise of his option and notified Thrift that they were ready to sell.

On the same day Thrift learned that Butler Loan had accepted its offer, Thrift received a telegram from Shukis that he was exercising his option to buy the 90 shares.

On November 5, 1959, Butler Loan received copies of the proposed sales agreement and covenant not to compete. These documents were silent as to any allocation of purchase price between the stock and the covenant not to compete. At a special meeting of the board of directors of Butler Loan, held on the evening of November 5, 1959, Shukis was discharged as manager.

The covenant not to compete contained the same language for each shareholder. It provided that:

> NOW, THEREFORE, in consideration of the mutual promises and covenants contained herein, and intending to be legally bound hereby, the parties hereto agree as follows:
>
> 1. For a period commencing with the date of this agreement and ending November 1, 1965, the

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2. $80,000 ÷ 55% = $109,000. An official of Thrift testified that it was that company's policy to offer slightly less than the maximum amount in initial negotiations.

Stockholder shall refrain from engaging in the small loan business, and from entering the employ of any person, firm or corporation engaged in any such businesses in the City of Butler or in an area within fifteen miles from the City of Butler. In consideration therefor, Thrift agrees to pay to the Stockholder the sum of * * * payable forthwith upon the execution of this agreement.

2. The prohibition above provided shall not be deemed to inhibit the Stockholder from owning the capital stock of, making loans to or being a director of any small loan corporation; it shall, however, inhibit the Stockholder from in any manner whatsoever soliciting any small loan, consumer discount or sales finance business in said territory, from being employed at or in the business office of any small loan corporation in said territory, from actively participating in the management or policies thereof and from divulging to any person, firm or corporation other than Thrift, subsidiaries of Thrift and their officers and employees the names or addresses of past or present customers of Butler or any company owned by it.

Although Shukis' claim for 90 additional shares was still outstanding, the remaining stockholders of Butler Loan arranged for a closing with Thrift in the latter's home offices in Pittsburgh, Pennsylvania, on November 16, 1959. On that day the balance sheet of Butler Loan was as follows:

Assets

Cash		$ 24,113.69
Receivables		
Small loans (net)	$246,467.50	
Notes	7,700.00	254,167.50
Prepaid expenses		229.82
Furniture and fixtures		931.27
Butler County finance service		300.00
Butler County Conusmer Discount Co.		52,000.00
		$331,742.28

Liabilities and equity

Notes payable	$154,000.00
Accrued taxes	325.90
Miscellaneous liabilities	7,310.13
Common stock	1,000.00
Retained earnings	169,106.25
	$331,742.28

When they met, the petitioners were located in one room of Thrift's offices with their attorney, Linn Phillips, while Shukis and his attorney occupied another room. The officers of Thrift made it clear to the petitioners that Thrift's price was fixed, and that the cost of issuing any additional shares to Shukis would be borne by the remaining stockholders. Since Thrift was a disinterested party in the dispute between Shukis and the petitioners, it did not participate in the negotiations which followed.

Throughout the afternoon the shareholders of Butler Loan attempted to reconcile their differences. Late in the day Shukis finally agreed to accept $10,153.21 of the total purchase price to be paid by Thrift for his 10 shares of outstanding stock *and* his claim for 90 additional shares, by executing an agreement which provided in part:

> KNOW ALL MEN BY THESE PRESENTS that I, Alvin C. Shukis, 222 Muntz Avenue, Butler, Pennsylvania for myself, executors, administrators and assigns do hereby acknowledge receipt of the sum of $10,153.21 from Butler County Loan Company and Carl L. Danielson, H. Pauline Danielson, H. C. McLennan, Kathryn [sic] E. [McLennan], Helen Sherman and Jacob F. Schaffner stockholders and directors of Butler County Loan Company. This payment is in full settlement of all claims and demands of the said Alvin C. Shukis against Butler County Loan Company, its successors and assigns and said stockholders and directors, their executors, administrators and assigns.
>
> In consideration of the payment of the same the said Alvin C. Shukis, for himself, his executors, administrators and assigns hereby releases and discharges Butler County Loan Company, its successors and assigns and said stockholders, and directors their executors, administrators and assigns from any and all liability to him arising either from his employment as Manager of the Butler County Loan Company and all matters incident thereto including the right to purchase capital stock of the Butler County Loan Company, or any other reason.

The $10,153.21 price was reached by giving Shukis the following:

10 shares issued in his name	$ 3,567.20
100% profit on 10 additional shares	1,317.20
50% profit on 80 remaining shares	5,268.81
	$10,153.21[3]

Petitioners then notified Thrift that they were ready to proceed with the closing. Without any prior notification or discussion with petitioners, Thrift had unilaterally decided to allocate roughly $152 of the purchase price per share to the covenant not to compete and the remaining $222 to the stock. This decision had been made before submission of the bids to Butler Loan on November 3, 1959, but no mention of the proposed allocation was made at that time to the petitioners or to Shukis.

Shukis executed the sales contract for his 10 shares and the covenant not to compete while still separated from the petitioners. The amount of $7,924 was allocated to his covenant not to compete and $2,229.21 to the sales agreement. Shukis had held his 10 shares of stock for less than six months, and in no event could he expect capital gains treatment on any portion of his profit. After briefly discussing the provisions of the documents with Thrift's officials, Shukis signed them and left Thrift's offices.

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3. It would have cost Shukis $20,250 to exercise his option to purchase 90 shares (90 times $225 equals $20,250). This $20,250, added to the $256,564 offered by Thrift ($374 times 686 shares) equals $276,814. But this would increase the number of shares outstanding by 90 shares, from 686 to 776. $276,814 divided by 776 shares equals $356.72 per share. Thus, Shukis' profit would have been $131.72 per share ($356.72 minus $225 equals $131.72).

Thrift then allocated the following amounts to petitioners' respective covenants not to compete:

Carl L. and Pauline Danielson	$34,569.73
Hugh E. and Katherine McLennan	20,968.52
Jacob F. Schaffner	12,751.13
Helen P. Sherman[4]	27,485.76

Thrift presented the covenants and sales agreement to the petitioners for signature. When they questioned the unexpected and large amounts allocated to the covenants not to compete, Thrift officials explained that the allocations were to Thrift's tax advantage. The Thrift officials did not tell the petitioners that they would receive capital gains treatment on the amounts allocated to the covenants, and Thrift also made no attempt to explain to the petitioners that these amounts would be taxable to them as ordinary income. At the conclusion of a brief discussion of the allocation, Phillips, their attorney, advised the petitioners to sign the documents. The petitioners then received Thrift's checks which bore the following notation: "Consideration for Capital Stock and agreement not to compete—Butler County Loan Company."

Petitioners reported the entire amount received by them as proceeds from the sale of capital assets. Respondent disallowed that portion which corresponded to the amount allocated to the covenants not to compete.

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4. Helen Sherman did not execute the covenant not to compete, but she received payment in full by a check which stated that both the stock and her covenant were being purchased.

ULTIMATE FINDINGS.

1. The amounts allocated to the covenants signed by the petitioners were in substance a part of the purchase price paid by Thrift for the stock of Butler Loan.

2. The fair market value of Butler Loan's stock on June 20, 1958, was $226.00 per share.

OPINION.

The key issue in this case involves the allocation of part of the purchase price received by petitioners to covenants signed by them not to compete. Respondent vigorously urges us to adopt a "new rule" of law concerning the treatment of such written covenants. The proposed "rule" would prevent either contracting party thereto *or* the respondent from subsequently attacking the stated consideration in such agreements unless fraud, duress or undue influence existed at the time they were signed. Petitioners, on the other hand, contend that the amounts assigned to the covenants do not reflect the real agreement of the parties.

We are unwilling to abdicate our judicial responsibility of examining the substance of a transaction. We are not bound by its form. Commissioner v. Court Holding Co., 324 U.S. 331 (1945); and Gregory v. Helvering, 293 U.S. 465 (1935). We are under no obligation to restrict ourselves to the written documents evidencing covenants not to compete, which, of course, would prevent us from arriving at a decision based on all the pertinent facts. It is true, however, that we do not view written agreements lightly, and our decisions generally reflect an adherence to this principle. See Ullman v. Commissioner, 264 F. 2d 305, 308 (C.A. 2, 1959), affirming 29 T.C. 129 (1957), where it was said that:

> * * * [W]hen the parties to a transaction such as this one have specifically set out the covenants in the contract and have there given them an assigned value, *strong proof* must be adduced by them in order to overcome that declaration. * * * [Emphasis supplied.]

See also *Clarence Clark Hamlin Trust*, 19 T.C. 718 (1953), affirmed sub. nom. Hamlin's Trust v. Commissioner, 209 F. 2d 761 (C.A. 10, 1954); Emmette L. Barran, 39 T.C. 515 (1962), affd. 334 F. 2d 58 (C.A. 5, 1964); Fred Montesi, 40 T.C. 511 (1963), affd. 340 F. 2d 97 (C.A. 6, 1965); and Rogers v. United States, 290 F. 2d 501 (C.A. 9, 1961).

Upon the entire record, after carefully considering all of the relevant facts of this transaction, we have reached the conclusion that the petitioners have presented the "strong proof" necessary to establish that the allocations of purchase price to the covenants do not reflect the substance of the agreement entered into by the parties.

The standard to be used in making such a factual determination was reiterated recently in Schulz v. Commissioner, 294 F. 2d 52, 55 (C.A. 9, 1961), affirming 34 T.C. 235 (1960):

> * * * [T]he covenant must have some independent basis in fact or some arguable relationship with business reality such that reasonable men, genuinely concerned with their economic future, might bargain for such an agreement.

Under these circumstances we are satisfied that the covenants here involved have no "independent basis in fact" or "arguable relationship with business reality."

There is nothing in the covenants which could prevent the petitioners, at any time after the sale of Butler Loan, from establishing a small loan company to duplicate, for all practical purposes, the business they sold. The petitioners were left entirely free to incorporate a new entity, own all its stock, elect themselves as its board of directors and, by the simple means of employing office personnel, conduct a small loan business essentially the same as Butler Loan's.

Aside from the language contained in the covenants, there are other factors that point to the lack of "independent basis in fact." The agreements signed by Shukis recited consideration of $7,924 for his covenant not to compete. Yet to Thrift, Shukis represented a selling stockholder owning only 10 shares. Using Thrift's allocation of purchase price, Shukis should have received roughly $2,220 for his stock and $1,540 for his covenant not to compete. The additional $6,393.21 he received did not represent consideration paid by Thrift as the result of an arm's length agreement with Shukis, but rather a settlement amount paid by the petitioners to Shukis for his option to purchase additional shares. As to this sum, Thrift was merely a conduit, acting under the direction of the petitioners. Thrift's allocation of this amount to the covenant indicates the extent to which the parties allowed the form of the agreement to govern its substance.

It is also significant to note the manner in which Thrift arrived at the amount it allocated to the covenants. Thrift ignored entirely the usual ingredients of noncompetition, such as age, previous experience, and likelihood of continued activity in the area. When the

agreements were executed, one of the petitioners was a 93 year old retired businessman who rarely left his home and whose affairs were conducted by his wife. Of the remaining petitioners, three were housewives with no knowledge of the small loan business. Only McLennan and Danielson remain. McLennan was in real estate and insurance work, residing and doing business some 60 miles beyond the area covered in the covenant. Danielson was a busy and successful surgeon. Neither of these men wanted to compete with Thrift in the small loan business in Butler again. But, even assuming their desire to do so, such competition would have obviously taken the form, used by them in Butler Loan, of being stockholders and directors. As previously pointed out, the covenants did not prevent any such threat of competition.

Finally, the sole criterion used by Thrift for determining the amout it would pay for Butler Loan's stock in excess of book value was a capitalization of "excess profits." No attempt was made to evaluate the relative importance of each stockholder as a competitive threat. No separate negotiations surrounding the covenants were ever conducted. Petitioners were at all times under the impression that they were selling the corporate assets of Butler Loan for $374 per share and that their respective covenants not to compete were mere formal assurances required by Thrift which had no real significance. For its part, Thrift intended to purchase the receivables of Butler Loan. It merely calculated the premium it would pay for such a purchase and then unilaterally attempted to change the tax treatment by calling the payment a covenant not to compete.

In Schulz, supra, the partners operating a tool manufacturing business desired to terminate the partnership so that one of them could enter a less risky business venture. The selling partner offered to sell his interest for $109,000 ($91,000 for assets and $18,000 for goodwill); the remaining partners, after meeting privately with their attorney, suggested the allocation of the $18,000 to a covenant not to compete rather than goodwill. The covenant prohibited competition for one year within a one mile radius of the existing business. The seller, ignorant of the tax consequences, executed a separate covenant with the stated consideration of $18,000. The seller did not have sufficient knowledge to compete with the partnership, and he was able to prove that he had no desire to do so. It was also established that, because of wartime shortages, the seller could not have reentered the field within the restricted time even if he had wanted to. On those facts we held that the agreement did not accurately reflect the intentions of the parties because the covenant purchased no real advantage for the buyers. It was in reality an attempt to transfer the goodwill of the business under another name.

Our decision here is essentially one of fact. Consequently, a prolonged discussion of the many cases in this area would only serve to point out their factual differences. Suffice it to say that the facts in the Schulz case are sufficiently close to the facts of this case to tip the judicial scales in petitioners' favor. In our opinion the covenants not to compete were not realistically bargained for by the parties. Accordingly, we hold that the amounts allocated by Thrift to the covenants not

to compete were in reality that part of the purchase price of the stock representing a premium on corporate receivables.

The second issue concerns the fair market value of Butler Loan's stock on June 20, 1958. On that date Helen Sherman acquired her stock in Butler Loan by reason of her husband's death. Section 1014, Internal Revenue Code of 1954,[5] provides that the basis of stock so received is its fair market value on that date.

In her 1959 Federal income tax return Helen Sherman reported a gain on the sale of her 194 shares of Butler Loan stock, using $226 per share as her basis. Respondent accepted this basis as correct. However, she claims in her petition that the basis of the stock sold by her in 1959 was $363.47 per share.

The value of stock at any particular time is a question of fact. After considering various valuations placed on the stock, the financial reports of Butler Loan, its record of earnings, the nature of the small loan business and the prevailing practice of purchasing outstanding receivables at a premium when the business is sold, we have concluded that on June 20, 1958, the fair market value of such stock was $226 per share.

Decisions will be entered under Rule 50.

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5. SEC. 1014. BASIS OF PROPERTY ACQUIRED FROM A DECEDENT.

(a) In General.—Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death * * *.

Tax Court — Decision

TAX COURT OF THE UNITED STATES

CARL L. DANIELSON and PAULINE S. DANIELSON, Petitioners, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.	Docket No. 1779-63

DECISION

Pursuant to the opinion of the Court filed July 12, 1965, and the agreed computation of the tax liability filed by the parties; and incorporating herein the facts recited in the compuation as the fiindings of the Court, it is

ORDERED and DECIDED: That there is no deficiency in income tax due from, or overpayment due to, the petitioners for the taxable year 1959.

(Signed) HOWARD A. DAWSON, JR.
Judge.

Entered: Sep. 22, 1965

It is hereby stipuated that the foregoing decision is in accordance with the opinion of the Court and the agreed computation of the parties, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision

entered herein, pursuant to the statute in such cases made and provided.

SIDNEY B. GAMBILL
Counsel for Petitioners.

(Signed) MITCHELL ROGOVIN, DHW
Chief Counsel,
Internal Revenue Service.

Tax Court — Decision

TAX COURT OF THE UNITED STATES

HUGH E. McLENNAN and KATHERINE McLENNAN,
Petitioners,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 473-64

DECISION

Pursuant to the opinion of the Court filed July 12, 1965, and the agreed computation of the tax liability filed by the parties; and incorporating herein the facts recited in the computation as the findings of the Court, it is

ORDERED and DECIDED: That there is no deficiency in income tax due from, or overpayment due to, the petitioners for the taxable year 1959.

(Signed) HOWARD A. DAWSON, JR.
Judge.

Entered: Sep. 22, 1965

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the agreed computation of the parties, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein, pursuant to the statute in such cases made and provided.

LINN V. PHILLIPS, JR.
Counsel for Petitioners.

(Signed) MITCHELL ROGOVIN, DHW
Chief Counsel,
Internal Revenue Service.

Tax Court — Decision

TAX COURT OF THE UNITED STATES

HELEN P. SHERMAN,
Petitioner,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

} Docket No. 5489-63

DECISION

Pursuant to the opinion of the Court filed July 12, 1965, and the agreed computation of the tax liability filed by the parties; and incorporating herein the facts recited in the computation as the findings of the Court, it is

ORDERED and DECIDED: That there is no deficiency in income tax due from, or overpayment due to, the petitioner for the taxable year 1959.

(Signed) HOWARD A. DAWSON, JR.
Judge.

Entered: Sep. 22, 1965

It is hereby stipuated that the foregoing decision is in accordance with the opinion of the Court and the agreed computation of the parties, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein, pursuant to the statute in such cases made and provided.

SIDNEY B. GAMBILL
Counsel for Petitioners.

(Signed) MITCHELL ROGOVIN, DHW
Chief Counsel,
Internal Revenue Service.

Tax Court — Decision

TAX COURT OF THE UNITED STATES

ESTATE OF JACOB F. SCHAFFNER, DECEASED, ELIZABETH SCHAFFNER and ERWIN MARSCH, EXECUTORS, and ELIZABETH SCHAFFNER, Petitioners,
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 344-64

DECISION

Pursuant to the opinion of the Court filed July 12, 1965, and the agreed computation of the tax liability filed by the parties; and incorporating herein the facts recited in the computation as the findings of the Court, it is

ORDERED and DECIDED: That there is no deficiency in income tax due from, or overpayment due to, the petitioners for the taxable year 1959.

(Signed) HOWARD A. DAWSON, JR.
Judge.

Entered: Sep. 22, 1965

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the agreed computation of the parties, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein, pursuant to the statute in such cases made and provided.

SIDNEY B. GAMBILL
Counsel for Petitioners.

(Signed) MITCHELL ROGOVIN, DHW
Chief Counsel,
Internal Revenue Service.

In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 382

CARL L. DANIELSON AND PAULINE S. DANIELSON, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

HELEN P. SHERMAN, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ESTATE OF JACOB F. SCHAFFNER, DECEASED, ELIZABETH SCHAFFNER AND ERWIN MARSCH, EXECUTORS, AND ELIZABETH SCHAFFNER, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

HUGH E. MCLENNAN AND KATHERINE MCLENNAN, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

A seller of the stock of a corporate business commonly covenants not to compete with the buyer for a

273-414—67

specific period in a given locale. The amounts paid for the ~~business~~ stock result in a capital gain or loss to the seller. Money paid for a covenant not to compete is, on the other hand, ordinary income to the seller and may be amortized by the buyer. *E.g., Ullman* v. *Commissioner*, 264 F. 2d 305 (C.A. 2). The question presented here is whether sellers of ~~a business~~ such stock, who simultaneously covenanted not to compete with the buyer, may ignore, and thereby secure capital gain treatment of, the portion of the total price which the written contract ascribed to the covenant on the ground that the covenant was without "substance," even though there is no evidence of fraud or other grounds that could be invoked as a defense in a suit by the buyer against the seller.

Petitioners were stockholders of a corporation engaged in the small loan business in Butler, Pennsylvania. They sold their stock to Thrift Investment Corporation by an agreement that gave each petitioner $374 per share. Through a covenant in the agreement each agreed not to compete with Thrift for six years in the Butler area, except through owning stock in another small loan corporation. The contract stated that each seller was being paid $222 for each share of stock he owned, and an additional $152 per share for a "non-compete" agreement.

Thrift claimed a deduction based on amortization over a six year period of the amounts apportioned to the noncompete agreements. Petitioners, however, reported the entire amount received as resulting from the sale of their stock. The Commissioner issued notices of deficiency based on the view that the

amounts apportioned to the non-compete agreements were ordinary income.

In a resulting suit for redetermination the Tax Court ruled in favor of petitioners, holding that "the amounts allocated by Thrift to the covenants not to compete were in reality that part of the purchase price of the stock representing a premium on corporate receivables" (Pet. App. 61–62). The United States Court of Appeals for the Third Circuit, which *sua sponte* granted rehearing *en banc*, vacated the Tax Court decision by a vote of 4 to 3. The appellate court, in adopting a rule which the Commissioner proposed, held (Pet. 22–23):

> a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.

This rule is consistent with positions expressed by other circuits in comparable circumstances, and is not in conflict with decisions of this Court. There is no occasion for further review.

1. The Second, Fifth, Sixth, Ninth, and Tenth Circuits have each decided at least one case factually similar to the present one. Althought no prior opinion has expressed the verbal formulation adopted here, the courts of appeals have not allowed a single taxpayer to avoid a written allocation of payment to an agreement not to compete.

Hamlin's Trust v. *Commissioner*, 209 F. 2d 761 (C.A. 10) was first, and on its facts bears the greatest resemblance to the present case. The taxpayers argued that "the basic transaction never involved any agreement in respect of the relative value of the stock and the covenant." 209 F. 2d at 764. In ruling that the tax consequences must nonetheless rest on the written apportionment of part of the purchase price to the covenant, the Tenth Circuit reasoned (*id.* at 765):

> It is reasonably clear that the sellers failed to give consideration to the tax consequences of the provision, but where parties enter into an agreement with a clear understanding of its substance and content, they cannot be heard to say later that they overlooked possible tax consequences. While acting at arm's length and understandingly, the taxpayers agreed without condition or qualification that the money received should be on the basis of $150 per share for the stock and $50 per share for the agreement not to compete. Having thus agreed, the taxpayers are not at liberty to say that such was not the substance and reality of the transaction. * * *

Next came *Ullman* v. *Commissioner*, *supra*. In expressly agreeing with the Tenth Circuit's decision in *Hamlin*, the Second Circuit stated (264 F. 2d at 308):

> when the parties to a transaction such as this one have specifically set out the covenants in the contract and have given them an assigned value, strong proof must be adduced by them in order to overcome that declaration. * * *

The same "strong proof" articulation has been accepted in the Fifth Circuit, *e.g.*, *Barran* v. *Commissioner*, 334 F 2d 58, and the Sixth, *Montesi* v. *Commissioner*, 340 F. 2d 97.

The Ninth Circuit has also approved the rule of *Hamlin*. In a case where the "taxpayers probably have been maneuvered by their purchaser into a big tax disadvantage," that court held: "Third parties may question the resolutions of parties to a contract, but in the absence of fraud it is not ordinarily open to the bargainers to do so." *Rogers* v. *United States*, 290 F. 2d 501.

The reasoning of *Hamlin* is in obvious accord with that adopted by the Third Circuit. Petitioners' claim is that the "strong proof" language, first used in *Ullman*, is in conflict with the result below. But their position utterly ignores that *Hamlin* was the foundation for the Second Circuit's decision in *Ullman*, that most subsequent decisions have relied on both *Hamlin* and *Ullman*, and that not a single court of appeals has suggested a conflict between *Hamlin* and *Ullman*. Petitioners themselves must recognize this lack of conflict, since they cite both cases as evidencing the "strong proof" rule (Pet. 12, n. 7).

What constitutes "strong proof" has not been defined by the courts which have used the phrase. Nothing in the cases suggests that any other circuit would have ruled for petitioners on the present record. Rather, the import of the decisions is that the "strong proof" called for would be tantamount to proof that

fraud or a subterfuge was committed during the negotiations. Thus, as the Third Circuit stated here (Pet. 27):

> the "strong proof" rule would require that the taxpayer be held to his agreement absent proof of the type which would negate it in an action between the parties to the agreement.

2. Petitioners are wrong in their contention that the Third Circuit "undercuts" the rule that tax consequences must follow the "substance" and not the "form" of a transaction.[1] That rule allows the courts, in determining tax consequences, to ignore a label that contracting parties attach to their deal if the substance of the transaction makes the label inappropriate. Thus in *Helvering* v. *Lazarus & Co.*, 308 U.S. 252, 255, a purported transfer and leaseback was held to be a mortgage under the "established doctrine that a court of equity will treat a deed, absolute in form, as a mortgage, when it is executed as security for a loan of money." And in *Bartels* v. *Birmingham*, 332 U.S.

[1] Contrary to petitioners' contention (Pet. 10, n. 5) Section 7453 of the Internal Revenue Code has nothing to do with the determination of what is "substance" and what is "form." Petitioners may intend to argue that, in requiring the Tax Court to adhere to the rules of evidence applicable in the District of Columbia, Congress has required that parol evidence be admissible in tax litigation to the extent the District of Columbia courts would receive it in contract disputes. See Judge Staley's dissenting opinion below, at Pet. 35–36. But this position ignores the fact that the "parol evidence" rule is one of substance, and not one of evidence. *E.g.*, 4 Williston on *Contracts* § 631 (3d ed.); IX Wigmore on *Evidence* § 2400 (3d ed.); 3 Corbin on *Contracts* § 573. Moreover, parol evidence is generally used to explain ambiguities or supply omissions of contracts.

126, dance band leaders were found to be for Social Security purposes the employers of musicians, even though contracts called the dance hall operators the "employers", because the band leaders had the usual duties of the employer. In each case the "form" that the parties attached to the transaction was plainly a fiction, when compared to the rights and obligations each party had.[2]

It is doubtful whether petitioners have made any effective showing that the substance of their agreement with Thrift impeaches the form. From the outset of the negotiations, Thrift demanded an agreement not to compete, and petitioners agreed. In point of substance the contract restricted petitioners' right to compete with Thrift, and Thrift could enforce the agreement.

Petitioners make no contrary claim. Their claim is that Thrift paid more for the covenant, and less for the stock, than it should have.

But Thrift computed the amount it apportioned to the covenant in the manner usual in Thrift's other transactions of this nature. The record shows, moreover, that in bargaining with petitioners Thrift considered the tax consequences of the apportionment, and

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[2] There is no relevance to the present circumstances in such cases as *Helvering* v. *Tex-Penn Oil Co.*, 300 U.S. 481, affirming, 83 F. 2d 518 (C.A. 3). (See Pet. 11.) The problem there was the net tax consequences of several interrelated contracts with respect to money which one document recited was the "consideration" paid by one of several parties to a second. The case is but an example of the rule that extrinsic evidence may be used to determine whether consideration was in fact paid as recited. Compare *Richards* v. *Boyd*, 344 F. 2d 754, 757 (C.A. 3).

increased its offer accordingly (Pet. 16). The "form" of apportionment had a substantive effect on the price paid.

In any event, to allow a party in petitioners' place to litigate with the tax collector the fair value of the covenant would have untoward and undesirable results for taxpayers and government alike. Notwithstanding the bona fides of his bargaining, a party to a contract would never know whether the courts, at the instance of the other party, would remake the terms with a resulting change in tax consequences. The only alternative would be for a party such as Thrift whose legitimate tax planning was thus frustrated to file a separate suit and seek a different result in a different forum, thereby defeating the public interest in uniform administration of the tax laws.

In the ordinary case,

> [t]he tax avoidance desires of the buyer and seller * * * are ordinarily antithetical, forcing them, in most cases, to agree upon a treatment which reflects the parties' true intent with reference to the covenants, and the true value of them in money. [*Ullman* v. *Commissioner*, *supra* at 308.]

In virtually every case one party or both will consider the tax results of a bargain and adjust his negotiating stance accordingly. That happened here. Thus, the presumed tax consequences of the transaction increased the total amount paid petitioners. To permit petitioners then to attack the provision which allocated a specific sum to the agreement not to compete, absent proof of the type which would negate it in an action between petitioners and Thrift, would

grant petitioners a unilateral reformation of the contract and a resulting windfall. Nothing in the Tax Code or in any decision of any court calls for enriching petitioners by allowing them so to remake a closed and completed transaction to their own tax advantage.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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